Economic and Interest Rate Forecast (Link Asset Services)

1 Prospect for Interest Rates

1.1 The Council has appointed Link Asset Services (Treasury Solutions) as its treasury advisor and part of their service is to assist the Council in formulating a view on interest rates. The following table gives their central view (updated November 2019):

Rate (%)	Dec 2019	Mar 2020	Jun 2020	Sep 2020	Dec 2020	Mar 2021	Jun 2021	Sep 2021	Dec 2021	Mar 2022	Jun 2022	Sep 2022	Dec 2022	Mar 2023
Bank Rate	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3-Mth LIBID	0.70	0.70	0.70	0.80	0.90	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6-Mth LIBID	0.80	0.80	0.80	0.90	1.00	1.10	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12-Mth LIBID	1.00	1.00	1.00	1.10	1.20	1.30	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5-Yr PWLB	2.30	2.40	2.40	2.50	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.10	3.20	3.20
10-Yr PWLB	2.60	2.70	2.70	2.70	2.80	2.90	3.00	3.10	3.20	3.20	3.30	3.30	3.40	3.50
25-Yr PWLB	3.20	3.30	3.40	3.40	3.50	3.60	3.70	3.70	3.80	3.90	4.00	4.00	4.10	4.10
50-yr PWLB	3.10	3.20	3.30	3.30	3.40	3.50	3.60	3.60	3.70	3.80	3.90	3.90	4.00	4.00

1.2 The interest rate forecasts provided by Link Asset Services are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. On this basis, while UK Gross Domestic Product (GDP) growth is likely to be subdued in 2019 and 2020 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years which could in turn increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast and how far those increases will occur and rise to will be dependent on future economic data. The Link Asset Services forecasts as presented above therefore assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

1.3 Risks to this interest rate forecast on differing Brexit outcomes include:

- In the event of an orderly non-agreement exit in December 2020 it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall (impacting on borrowing rates).

- If there was a disorderly Brexit then any cut in Bank Rate would likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England and it is possible that the government could act to protect economic growth by implementing additional fiscal stimulus.

1.4 A further risk to interest rate forecasts is that all central banks are now working in very different economic conditions than before the 2008 financial crash, as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed since 2008. This means that the neutral rate of interest in an economy (that being the rate that is neither expansionary nor deflationary) is difficult to determine definitively in this new environment; although central banks have made statements that they expect it to be much lower than before 2008. Going forward central banks could therefore either over or under do increases in central interest rates in their efforts to maintain effective monetary policy.

1.5 Borrowing Rates: As shown in the above forecasts provided by Link Asset Services, the overall longer run future trend is for UK gilt yields, and consequently Public Works Loan Board (PWLB) rates to rise, albeit gently. From time to time however, gilt yields can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment; such volatility could occur at any time during the forecast period.

1.6 In addition, PWLB rates are subject to ad-hoc decisions by HM Treasury to change the margin over gilt yields charged in PWLB rates; as demonstrated in October 2019 when HM Treasury unexpectedly announced their decision to increase the margin over gilt yields by an additional 1% (to 180 basis points) on loans lent to local authorities; having the aim of increasing PWLB borrowing rates back to 2018 levels. It remains unclear whether or not this extra 100 basis points margin would be reversed if gilt yields were to rise back up again by over 100bps within the next year or so.

1.7 Other downside/upside risks to the current forecasts for UK gilt yields, and therefore corresponding PWLB borrowing rates, include:

Downside Risks	Upside Risks
• **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth *(however there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has diminished)*. • **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.	• **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK. • The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

Downside Risks	Upside Risks
• A **potential for a re-run of the 2008 financial crisis** centred on huge debt accumulated by corporations during the decade of low interest rates; as stated by the IMF in a report issued in October 2019 on the World Economic Outlook which also flagged up a synchronised slowdown in world growth. At the same time the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels. • A resurgence of the **Eurozone sovereign debt crisis** given concerns centred on various EU minority governments dependent on coalitions which could prove fragile *(including, Austria, Belgium, Germany, Italy, Netherlands, Portugal, Spain and Sweden)*; and weak capitalisation of some **European banks**, particularly Italian banks • **Geopolitical risks,** for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.	• **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

1.8 Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. The above forecasts (and Bank of England monetary policy decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

1.9 Full details of economic commentaries and interest rate forecasts as provided by Link Asset Services are held by the Director of Finance Support Services (Financial Reporting: Treasury Management Team).

2 Investment and Borrowing Rates

2.1 Investment returns are likely to remain low during 2020/21 with little increase in the following two years. Based on the current Link Asset Services central assumptions for interest rates, the suggested budgeted earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Average Earnings per Financial Year	**Nov-19 Forecast**
2019/20	0.75%
2020/21	0.75%
2021/22	1.00%
2022/23	1.25%
2023/24	1.50%
2024/25	1.75%
Later years	2.25%

2.2 If major progress was however made with an agreed Brexit including the terms of a trade deal with the EU during 2020 (or soon after) then there is upside potential for investment income over the above periods.

2.3 **Borrowing Advice:** Borrowing interest rates were on a major falling trend during the first half of 2019/20; significantly narrowing the 'cost of carry' effecting revenue budgets (that being the difference between higher borrowing costs and lower investment returns). Whilst this gave local authorities the opportunity to take new borrowing from the PWLB (as opposed to the policy of avoiding new borrowing by running down spare cash balances) the unexpected increase of 100 bps in PWLB rates implemented in October 2019 requires local authorities to revisit their borrowing and risk management strategies.

2.4 Now that the gap between longer term PWLB borrowing rates and investment rates has once again materially widened, consideration should be given to sourcing funding at cheaper rates from the following:

- Local authorities (primarily for shorter dated maturities);
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates); and/or
- Municipal Bonds Agency (no issuance at present but there is potential).

2.5 In addition, authorities who have recently taken new PWLB borrowing could temporarily return to a policy of internal borrowing in 2020/21, thereby minimising the resulting revenue costs whilst other funding sources as an alternative to the PWLB are considered. This policy would however need to be carefully reviewed to avoid incurring higher borrowing costs in the future at times when it may not be possible to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.